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No. 03-

IN THE

Supreme Court of the United States

DORIS STIEGLITZ WARD, individually and on behalf of all others similarly situated,

Petitioners,

v.

STATE OF SOUTH CAROLINA,

Respondent.

Petition for a Writ of Certiorari to the Supreme Court of South Carolina

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether South Carolina's Act 189, one of numerous state statutes enacted to cure the unconstitutionality of the states' discriminatory taxation of federal employees' retiree benefits under *Davis* v. *Michigan Department of Treasury*, 489 U.S. 803 (1989), is itself unconstitutional because the State simultaneously repealed the state retirees' tax exemption and increased state retirees' benefits for the purpose and with the effect of compensating state retirees for their increased tax obligations and thereby circumvented the requirement of equal treatment and perpetuated the discrimination found unlawful in *Davis*.

PARTIES TO THE PROCEEDING

All parties to the proceeding are identified in the caption.

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
PARTIES TO THE PROCEEDING	ii
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	1
STATUTORY PROVISIONS INVOLVED	1
INTRODUCTION	2
STATEMENT OF THE CASE	4
REASONS FOR GRANTING THE PETITION	10
I. THE SOUTH CAROLINA COURT'S DECISION BROADENS THE CONFLICT AMONG STATE COURTS ABOUT APPLYING THE INTERGOVERNMENTAL TAX IMMUNITY DOCTRINE UNDER *DAVIS*	10
II. THE SOUTH CAROLINA COURT'S OPINION IS IN SUBSTANTIAL TENSION WITH THIS COURT'S PRECEDENTS	18
III. THE CASE PRESENTS AN IMPORTANT AND RECURRING QUESTION OF FEDERAL LAW	23
IV. THE SOUTH CAROLINA COURT'S DECISION WAS WRONG	26
CONCLUSION	28

TABLE OF AUTHORITIES

CASES Page

Almeter v. *Va. Dep't of Taxation*, No. LL-821-4, 2000 WL 1687589 (Va. Cir. Ct. Nov. 6, 2000) 7, 15, 16
Brown v. *Mierke*, 443 S.E.2d 462 (W. Va. 1994) .. 6
Davis v. *Mich. Dep't of Treasury*, 489 U.S. 803 (1989) 2, 4, 5, 6, 24
Evans v. *South Carolina*, 543 S.E.2d 547 (S.C. 2001) 17
Fair Assessment in Real Estate Ass'n, Inc. v. *McNary*, 454 U.S. 100 (1981) 25
Fonger v. *Dep't of Treasury*, 483 N.W.2d 920 (Mich. Ct. App. 1992) 6
Green v. *County Sch. Bd.*, 391 U.S. 430 (1968) 21
Harper v. *Va. Dep't of Taxation*, 401 S.E.2d 868 (Va.), *vacated on other grounds*, 501 U.S. 1247 (1991) 6
Harper v. *Va. Dep't of Taxation*, 509 U.S. 86 (1993) 4, 6
Hogan v. *Musolf*, 471 N.W.2d 216 (Wis. 1991) 6
Jefferson County, Ala. v. *Acker*, 527 U.S. 423 (1999) 4, 23, 26
Jinks v. *Richland County, S.C.*, 538 U.S. 456 (2003) 2
Kerr v. *Killian*, No. CV-03-0110-PR, 2004 WL 258200 (Az. Feb. 13, 2004) 23
McCulloch v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819) 4, 24
McClead v. *Pima County*, 849 P.2d 1378 (Az. Ct. App. 1992) 7
Milliken v. *Bradley*, 433 U.S. 267 (1977) 21
Parrish v. *Employees' Ret. Sys.*, 398 S.E.2d 353 (Ga. 1990) 7
Pierce v. *State*, 910 P.2d 288 (N.M. 1995) 7

TABLE OF AUTHORITIES – continued

Page

Ragsdale v. *Dep't of Revenue*, 895 P.2d 1348 (Or. 1995) 7, 12, 13
Reynoldsville Casket Co. v. *Hyde*, 514 U.S. 749 (1995) 19
Sheehy v. *Pub. Employees Ret. Div.*, 864 P.2d 762 (Mont. 1993) 7, 11, 12, 27
South Carolina v. *Baker*, 485 U.S. 505 (1988) 2
Strelecki v. *Okla. Tax Comm'n*, 872 P.2d 910 (Okla. 1993) 7
Thompson v. *Utah State Tax Comm'n*, No. 20030506-SC (Utah, filed June 13, 2003) 7, 25
United States v. *Virginia*, 518 U.S. 515 (1996) 21
Vogl v. *Dep't of Revenue*, 960 P.2d 373 (Or. 1998) ..... *passim*
Ward v. *South Carolina*, 538 S.E.2d 245 (S.C. 2000) 8, 17
W. Lynn Creamery, Inc. v. *Healy*, 512 U.S. 186 (1994) 3, 18, 20, 22, 26
Wright v. *Council of Emporia*, 407 U.S. 451 (1972) 21

STATUTES

4 U.S.C. § 111 ..... 1, 4, 5
28 U.S.C. § 1341 25
1989 Iowa Acts ch. 228, § 1 6
§ 2 6
§ 8 6
1989 La. Acts 812, § 1 6
1989 N.Y. Laws ch. 664, § 1 6
1989 N.C. Sess. Law ch. 792 7
Act 189, § 39, 1989 S.C. Acts 623 ..... 2, 8
Act 189, § 60, 1989 S.C. Acts 623 ..... 2, 8
1989 Va. Acts Spec. Sess. II, ch. 3 7
1990 N.M. Laws ch. 49 7

TABLE OF AUTHORITIES – continued

	Page
1990 Va. Acts ch. 507	7
ch. 525	7
1991 Or. Laws ch. 823, § 1	7
ch. 823, § 3	7
1993 Miss. Laws ch. 523, § 1	6
Ark. Code Ann. § 26-51-307	6
Colo. Rev. Stat. Ann. § 39-22-104(4)	6
Kan. Stat. Ann. § 79-32,117(c)	6
Ky. Rev. Stat. Ann. § 141.021	6
Ga. Code Ann. § 48-7-27(a)	6
Mo. Rev. Stat. § 143.124	6
S.C. Code Ann. § 12-7-210 (1976)	8
§ 12-6-510(A) (2000)	8
Utah Code Ann. § 49-11-701	7

SCHOLARLY AUTHORITY

Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 Mich. L. Rev. 2167 (1997) 17, 22, 24

PETITION FOR CERTIORARI

Petitioners, Doris Steiglitz Ward individually and on behalf of all others similarly situated, respectfully petition for a writ of certiorari to review the judgment of the Supreme Court of South Carolina in this case.

OPINIONS BELOW

The opinion of the Supreme Court of South Carolina (App. 1a-8a) was entered on December 8, 2003, and is reported at 590 S.E.2d 30 (S.C. 2003). The order denying petitioners' cross-motion for partial summary judgment and granting the State's cross-motion for summary judgment (App. 10a-25a) was entered on August 26, 2002, and is not reported. The order denying the petitioners' motion to alter or amend (App. 9a) was entered on September 17, 2002, and is not reported.

JURISDICTION

The Supreme Court of South Carolina entered its decision and judgment on December 8, 2003. This Court has jurisdiction pursuant to 28 U.S.C. § 1257.

STATUTORY PROVISIONS INVOLVED

This case involves the application of the Public Salary Tax Act to South Carolina's Act 189.

The Public Salary Tax Act, 4 U.S.C. § 111(a), provides as follows:

> (a) General Rule. – The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a

> duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

The pertinent sections of Act 189, §§ 39, 60, 1989 S.C. Act 623, are set forth in App. 26a-33a.

INTRODUCTION

In *Davis* v. *Michigan Department of Taxation*, 489 U.S. 803, 817 (1989), this Court invalidated tax laws in nearly half the states because they discriminated against federal retirees by exempting state retirement benefits from taxation without providing a similar exemption for federal retirement benefits. The Court further held that "the appropriate remedy 'is a *mandate* of equal treatment,'" but left to the 23 affected States the question whether to accomplish that result "'by withdrawal of benefits from the favored class'" or "'by extension of benefits to the excluded class.'" *Id.* at 817-18. A number of these States decided to do neither, and instead to circumvent the mandate of equal treatment by simultaneously eliminating state retirees' exemptions and compensating those retirees for the new taxation.

Some state courts have held that the state legislatures' attempts to perpetuate this intergovernmental discrimination is unconstitutional; but others, including the South Carolina Supreme Court in the decision below, have approved these attempts to evade the anti-discrimination mandate that is embodied in the intergovernmental tax immunity doctrine. Relying (as it has before)[1] on the Tenth Amendment to

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[1] *See Jinks* v. *Richland County, S.C.*, 538 U.S. 456 (2003) (rejecting South Carolina Supreme Court's holding that federal tolling statute infringes upon the State's Tenth Amendment rights); *South Carolina* v. *Baker*, 485 U.S. 505 (1988) (rejecting South Carolina Supreme Court's holding that the Tax Equity and Fiscal Responsibility Act of 1982

support the State's claim to an unfettered right to determine state employee and retiree compensation, the South Carolina Supreme Court held that "the doctrine of intergovernmental tax immunity does not deprive a state of its sovereignty to establish the level of its employees' compensation as long as the State does not discriminate in taxation based on the source of the income." App. 3a. Thus, the court opined, "*any* restriction on th[e State's compensation] authority would violate the Tenth Amendment." *Id.* at 4a (emphasis supplied).

This petition, accordingly, arises from the conflict among state courts created by state legislatures' attempts to overhaul state taxation provisions that are unconstitutional under this Court's decision in *Davis*. The decision below broadens this conflict: two state courts have struck down statutes that the South Carolina court's test would have upheld; while another state court has, like South Carolina, permitted the state's evasive action. Yet another case is pending in Utah, and other similar statutes remain to be challenged.

It is not only this conflict which warrants the exercise of certiorari review. South Carolina's decision is also in significant tension with decisions of this Court. It is an illegitimate remedial response to the equal treatment mandate in *Davis*, because it seeks to continue rather than to cure discrimination. And, the decision cannot be squared with *West Lynn Creamery, Inc.* v. *Healy*, 512 U.S. 186 (1994), which held that a facially non-discriminatory tax is unconstitutional under the analogous jurisprudence of the dormant Commerce Clause if it is indisputably linked to a compensating subsidy.

Moreover, the question presented is both important and recurring. The intergovernmental tax immunity doctrine is one of the basic constitutional mechanisms that safeguards the balance of power between the federal and state governments.

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compels the State to issue bonds in registered form in violation of the Tenth Amendment).

See *McCulloch* v. *Maryland*, 17 U.S. (4 Wheat.) 316 (1819); accord, *Jefferson County, Ala.* v. *Acker*, 527 U.S. 423, 436-37 (1999); *Harper* v. *Va. Dep't of Taxation*, 509 U.S. 86 (1993). South Carolina's application of that doctrine, if upheld, will eviscerate the protection provided by the doctrine, allowing its facile evasion so long as discriminatory taxation is labeled "compensation" or a "subsidy." Importing this rule into the closely analogous dormant Commerce Clause area would similarly erode that constitutional prohibition against discrimination.

In addition, this case has substantial practical implications for federal employees and retirees across the country. If states can so easily evade the mandate of *Davis* and the intergovernmental tax immunity doctrine, states may impose burdensome taxation on federal employees and retirees while protecting their own employees and retirees with compensatory increases, without incurring any political cost.

This petition will allow the Court to resolve the conflict among state courts about the constitutional requirement of equal treatment under the intergovernmental tax immunity doctrine, to foreclose the evasion of its mandate in *Davis*, to ensure the consistent development of its jurisprudence under the intergovernmental tax immunity doctrine and the dormant Commerce Clause, and to prevent discriminatory state taxation of federal employees and retirees now and in the future. For these reasons, this Court should grant certiorari.

STATEMENT OF THE CASE

1. In *Davis* v. *Michigan Department of Taxation*, 489 U.S. 803 (1989), a federal retiree challenged Michigan's taxation regime, which defined "taxable income" to include federal retirement benefits and exclude similar benefits received by former employees of the State or its political subdivisions. The Michigan Court of Appeals had held that the Public Salary Tax Act, 4 U.S.C. § 111, forbids discriminatory

taxation against federal "employees," but not against federal annuitants, including federal retirees. It also held that the intergovernmental tax immunity doctrine did not render Michigan's disparate tax treatment unconstitutional under a rational basis test, because the State had a legitimate interest in using favorable tax treatment to attract and retain qualified employees. The Supreme Court of Michigan denied the federal retiree's application for leave to appeal.

This Court reversed. First, it concluded that retirement benefits were deferred compensation for past years of service rendered to the federal government and therefore were covered by the Public Salary Tax Act. 489 U.S. at 808-09.

Second, the Court held that Congress codified the constitutional doctrine of intergovernmental tax immunity when it enacted § 111. *See id.* at 813. Section 111 specifies that the Government consents to state taxation of federal employees' compensation only "if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation," 4 U.S.C. § 111(a). See 489 U.S. at 812 (§ 111 "closely parallels the nondiscrimination component of the constitutional immunity doctrine which has, from the time of *McCulloch* v. *Maryland*, barred taxes that 'operat[e] so as to discriminate against the Government or those with whom it deals'") (alteration in original). Because the intergovernmental tax immunity doctrine shields current and former federal employees from discriminatory taxation, a state must justify disparate tax treatment on the basis of significant differences between classes of taxpayers. See *id.* at 816. Because Michigan was unable to justify its discriminatory taxation of federal retirement benefits, this Court concluded that the State had violated the principles of the intergovernmental tax immunity doctrine. *Id.* at 817.

The Court nonetheless declined to order a specific remedy for the discriminatory taxation. Instead, it held that "the appropriate remedy 'is a *mandate* of equal treatment, a result

that can be accomplished by withdrawal of benefits from the favored class as well as by extension of benefits to the excluded class.'" *Id.* at 817-18 (quoting *Heckler* v. *Mathews*, 465 U.S. 728, 740 (1984)). This Court allowed the states to decide which of these alternative remedies they would adopt to eliminate discrimination in their taxation schemes.

2. When *Davis* was decided, the tax codes of 23 states discriminated in some manner against federal retirees. *Harper*, 509 U.S. at 93 & n.5 (citing state codes); see also *Harper* v. *Va. Dep't of Taxation*, 401 S.E.2d 868, 871 n.2 (Va.) (citing all 23 state codes), *vacated on other grounds*, 501 U.S. 1247 (1991). Many states responded to this Court's mandate of equal treatment by extending to federal retirees the same tax exemptions available to state retirees.[2] Other states chose to withdraw the exemptions that favored state retirees, bearing the political consequences of that decision.[3]

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[2] *See* Ark. Code Ann. § 26-51-307 (exempting first $6000 of all retirement income); Colo. Rev. Stat. Ann. § 39-22-104(4)(f) (exempting all pensions); Kan. Stat. Ann. § 79-32,117(c)(vii) (exempting federal benefits from taxation); Ky. Rev. Stat. Ann. § 141.021 (exempting all federal retirement benefits from taxation); 1989 La. Acts 812, § 1 (amending La. Rev. Stat. Ann. § 47:44.2 to exempt all federal retirement pay from state taxation); *Fonger* v. *Dep't of Treasury*, 483 N.W.2d 920, 921-22 (Mich. Ct. App. 1992) (per curiam) (describing enactment extending exemption to federal retirees); 1993 Miss. Laws ch. 523, § 1 (amending Miss. Code Ann. § 27-7-15(4)(k) to exempt federal benefits from taxation); Mo. Rev. Stat. § 143.124 (providing tax exemption for first $6000 of retirement income for state and federal retirees); 1989 N.Y. Laws ch. 664, § 1 (amending N.Y. Tax Law § 612(c)(3) to exempt federal pensions from state taxation); *Brown* v. *Mierke*, 443 S.E.2d 462 (W. Va. 1994) (describing West Virginia's response to *Davis*); *Hogan* v. *Musolf*, 471 N.W.2d 216, 218-19 (Wis. 1991) (noting passage of statute extending tax exemption to federal retirement income). Iowa took a middle course, eliminating the tax exemption for state retirement benefits and replacing it with a partial tax exemption for both federal and state benefits. *See* 1989 Iowa Acts ch. 228, §§ 1, 2, 8.

[3] *See* Ga. Code Ann. § 48-7-27(a)(4), (5) (replacing total exemption for state benefits with a partial exemption equivalent to the partial exemption

A third group of states, however, manipulated their taxation and benefits regimes to test *Davis*' mandate of non-discrimination – *viz.*, they withdrew the discriminatory exemption in favor of former state employees while simultaneously compensating those retirees for the loss of their favored tax status vis-à-vis federal retirees. For example, Montana responded to *Davis* by subjecting all retirement income (including state pensions) to state income tax and offsetting that tax by increasing retirement pay to state retirees who were Montana residents. See *Sheehy* v. *Pub. Employees Ret. Div.*, 864 P.2d 762, 764 (Mont. 1993). With limited variations, several others states similarly eliminated a tax exemption for state retirement benefits with one hand, while restoring retirement benefits with the other.[4]

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available to federal retirees); 1990 N.M. Laws ch. 49 (repealing tax exemptions for state retirement benefits), *cited in Pierce* v. *State*, 910 P.2d 288, 292 (N.M. 1995); *Strelecki* v. *Okla. Tax Comm'n*, 872 P.2d 910, 911 n.4 (Okla. 1993) (discussing elimination of total exemption for state retirement benefits and new partial exemption that had applied to federal retirement benefits); *see also Parrish* v. *Employees' Ret. Sys.*, 398 S.E.2d 353, 353-54 (Ga. 1990) (describing Georgia's legislative response to *Davis*).

[4] *See McClead* v. *Pima County*, 849 P.2d 1378, 1381 n.2 (Az. Ct. App. 1992) (characterizing 1989 Ariz. Sess. Laws ch. 310 as "a permanent increase in base benefits known as a 'tax equity benefit allowance'"); 1989 N.C. Sess. Law ch. 792 (eliminating tax exemption for state and local government retirees and providing for adjustment payments then and in the future); 1991 Or. Laws ch. 823, §§ 1, 3 (amending Or. Rev. Stat. § 237.201 to repeal tax exemption for state retirement benefits), *cited in Vogl* v. *Dep't of Revenue*, 960 P.2d 373, 375-77 (Or. 1998); Utah Code Ann. § 49-11-701; 1989 Va. Acts Spec. Sess. II, ch. 3 (repealing exemption for state benefits), *cited in Almeter* v. *Va. Dep't of Taxation*, No. LL-821-4, 2000 WL 1687589, at *1 (Va. Cir. Ct. Nov. 6, 2000); 1990 Va. Acts chs. 507, 525 (increasing state pension benefits to offset the new tax); *Ragsdale* v. *Dep't of Revenue*, 895 P.2d 1348, 1350 (Or. 1995) (en banc) (same); *Thompson* v. *Utah State Tax Comm'n*, No. 20030506-SC (Utah, filed June 13, 2003) (challenging the Utah tax scheme in the state supreme court).

3. South Carolina is among those states that purported to eliminate its retirees' facial tax exemption while maintaining the disparate treatment of state and federal retirees by compensating state retirees for the loss of that favored treatment. Prior to *Davis*, South Carolina exempted all state retirement benefits from taxation, but only the first $3000 of federal retirement benefits. In response to *Davis*, the South Carolina General Assembly passed Act 189, which repealed the tax exemption for state retirement benefits, thereby rendering both state and federal retirement benefits in excess of $3000 subject to taxation. Act 189, § 39, 1989 S.C. Acts 623 ("Act 189"). That same act, however, simultaneously increased benefits for state retirees by seven percent, *id.* § 60, which was and remains today the highest marginal tax rate in South Carolina, see S.C. Code Ann. § 12-7-210 (1976); *id.* § 12-6-510(A) (2000).

4. In 1998, petitioners commenced a class action alleging that Act 189 was unconstitutional and seeking an injunction against future taxation and damages for past paid taxes. See *Ward* v. *South Carolina*, 538 S.E.2d 245, 246 (S.C. 2000). After an initial ruling, appeal and remand concerning state jurisdictional issues, the circuit court upheld Act 189. See App. 1a.

The Supreme Court of South Carolina affirmed. App. 8a. In reaching its decision, the court recognized that *Davis* mandated equal tax treatment of federal and state retirees' benefits. The court, however, rejected petitioners' claim that South Carolina's seven percent increase in retirement benefits had recast the pre-*Davis* discriminatory tax exemption as a discriminatory tax rebate. See *id.* at 3a.

The court expressed the view that the South Carolina General Assembly had complied with the mandate of *Davis* by eliminating the exemption that advantaged state retirees. App. 3a-4a. In reaching this conclusion, the court observed that "[t]he State does not dispute that the General Assembly increased retirement benefits to compensate state retirees, in

part, for their increased income tax obligations resulting from the enactment of Act 189," *id.* at 3a, but nonetheless rejected petitioners' argument that the "indisputable linkage" between Act 189's repeal of the tax exemption and its simultaneous increase in state retirement benefits rendered the scheme as a whole impermissibly discriminatory. *Id.* at 4a. Relying on the Tenth Amendment, the court explained that neither *Davis* nor the intergovernmental tax immunity doctrine precluded the State from raising retirement benefits even if the raise "serves to offset a prior tax exemption." *Id.* Put differently, the court believed that *Davis* was concerned only with *taxation*, and that state retiree *compensation* decisions were beyond its review. *Id.* at 5a ("*Davis* requires that the state *tax* federal and state retirees equally and does not concern itself with the manner in which a state chooses to *compensate* its retirees.").

In so concluding, the court emphasized that although the elimination of the exemption and the increase in compensation were simultaneous and although the State acknowledged its purpose to preserve the favored treatment of its own retirees, the computational correlation between the state retirees' new tax obligations after Act 189 and the seven percent increase in their benefits was not absolutely precise. App. 6a. On this basis, the court also sought to distinguish the Oregon Supreme Court's decision in *Vogl* v. *Department of Revenue*, 960 P.2d 373 (Or. 1998) – holding unconstitutional an Oregon statute compensating state retirees for the loss of their favored status – because the offsetting compensation provided by the Oregon statute was "mathematically correlated to replace the [state retirees'] lost state retirement income." App. 7a. The South Carolina court then attempted to distinguish a decision of the Montana Supreme Court – also holding unconstitutional an act that combined the repeal of a state retiree exemption and a state retiree benefit increase – on the ground that the Montana act applied only to

state retirees who were also state residents. See *id.* (discussing *Sheehy* 864 P.2d at 764, 768).

Moreover, the South Carolina court opined that its decision upholding Act 189 was consistent with an Oregon decision upholding a 1991 statute (enacted before Oregon's 1995 statute that was invalidated in *Vogl*) and with a Virginia decision upholding that state's statutory response to *Davis*. See App. 8a & n.2 (discussing *Ragsdale* v. *Dep't of Revenue*, 895 P.2d 1348 (Or. 1995) and *Almeter* v. *Va. Dep't of Taxation*, No. LL-821-4, 2000 WL 1687589 (Va. Cir. Ct. Nov. 6, 2000)).

REASONS FOR GRANTING THE PETITION

I. THE SOUTH CAROLINA COURT'S DECISION BROADENS THE CONFLICT AMONG STATE COURTS ABOUT APPLYING THE INTER-GOVERNMENTAL TAX IMMUNITY DOCTRINE UNDER *DAVIS*.

The decision below broadens an extant conflict among state supreme courts assessing the constitutionality of the remedies that state legislatures have enacted to cure the unconstitutional discrimination against federal employees identified in *Davis*. Specifically, the courts are in conflict about whether increases in state employees' compensation – even increases passed simultaneously with legislation eliminating discriminatory tax treatment and for the purpose of perpetuating the state employees' favored treatment – are unconstitutional. The courts are also divided, or at the very least deeply confused, about the showing that is required to demonstrate that increased compensation is in fact an unconstitutional tax rebate.

To date, two state supreme courts have struck down state laws that repeal a discriminatory tax exemption for state retirement benefits while simultaneously increasing the benefits paid to state retirees, holding that the laws constitute

a discriminatory tax rebate that violates the intergovernmental tax immunity doctrine set forth in *Davis*. See *Sheehy*, 864 P.2d at 768; *Vogl*, 960 P.2d at 379. These courts recognize that a state statute facially directed to the compensation of state employees may, in fact, be an unconstitutional tax rebate if the relevant evidence shows that the law is intended to perpetuate, and actually does perpetuate, discrimination against federal employees.

The Montana Supreme Court's decision in *Sheehy* addresses Montana's 1991 act, repealing its total tax exemption for state retirement income and replacing it with an exemption for the first $3600 of all pension and annuity income, phased out for higher income levels. 864 P.2d at 764. In the very same enactment, however, the Montana legislature also granted an annual retirement adjustment payment to all state retirees who were Montana residents and whose benefits were newly-subject to taxation because of *Davis*. *Id.* The Montana Supreme Court struck down the 1991 act, holding that the repeal of the tax exemption and the increase in retirement benefits were linked. *Id.* at 768 ("[t]he State's argument that the two portions of the bill are not related defies logic"). The court found the legislature's purpose entirely clear:

> [T]he relationship between the tax equalization provisions of the bill, with their negative impacts on state retirees, and the adjustment intended to make up, in part, for that equalization cannot be gainsaid. The adjustment – while purporting to be an adjustment to state retirement benefits – is in fact, an adjustment to the equalization achieved via the first sections of [the act]. This conclusion is inescapable given the inclusion of the adjustment in, and as part of, the tax equalization program. [*Id.* at 768.]

The court found additional evidence of the legislature's illegitimate purpose in the State's restriction of the adjustment to those living within the State and in the State's funding of

the benefit not from state retirement plan assets but from the State's general revenues. *Id.* From all of the above, the court concluded that "the adjustment is a partial tax rebate denominated otherwise in an attempt to evade the requirements of federal law," *id.*, and thus violates the Constitution.

The Oregon Supreme Court, too, has found unconstitutional an Oregon law simultaneously repealing a state retiree tax exemption and enacting a state retiree benefit increase. Prior to 1991, retirement benefits paid to Oregon public employees were exempt from all state taxes, but there was no similar exemption for federal retirement benefits. *Vogl*, 960 P.2d at 375. In 1991, the Oregon legislature enacted a response to *Davis*; the Oregon Supreme Court, sitting *en banc*, narrowly upheld the 1991 law over the dissent of Justice Gillette who characterized the 1991 act as "a legislative device specifically and narrowly tailored to avoid the rule of intergovernmental tax immunity that was explicated by the Supreme Court of the United States in *Davis*." *Ragsdale*, 895 P.2d at 1357 (Gillette, J., dissenting).[5]

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[5] Specifically, in 1991, in response to *Davis*, Oregon's legislature repealed the tax exemption for state retirees and increased the retirement benefits payable to state retirees who became subject to the new tax. *Ragsdale*, 895 P.2d at 1350. Additionally, the legislature provided that the increased benefits were to cease if state retirement benefits were exempted from Oregon's personal income taxation. *Id.* at 1351. The Oregon Supreme Court upheld the law, holding that the federal retiree's claim could succeed only if the increased retirement benefits paid to state retirees were tax rebates. The court found evidence pointing both ways: The State's concession that the 1991 benefit increase was intended to compensate state retirees for the increased tax liabilities, *id.* at 1352, and the termination of the increased retirement pay if state benefits became tax exempt both "point[ed] toward a tax rebate." *Id.* at 1354. On the other hand, the court found that *Davis* was concerned with taxation and not with the compensation a state paid its retirees and that, considering only taxation, the State had adopted one of the *Davis* Court's suggested remedies. *Id.* In addition, the court found that the new benefits were not limited to state residents, were not correlated with the amount of the

In 1995, however, Oregon amended its tax and benefits scheme for a second time, enacting an increased retirement benefit for any year in which state retirement benefits were not exempt from state personal income taxation. See *Vogl*, 960 P.2d at 376. This increase was tied to Oregon's income tax rate and applied only to the retirement benefits attributable to the period before the 1991 repeal of the state tax exemption. See *id.* at 376-77. This time, in an opinion authored by former dissenter Justice Gillette, the Oregon Supreme Court found that the tax and benefit scheme was an unconstitutional tax rebate under *Davis*. *Id.* at 379-80.

The *Vogl* court first explained that a benefits increase can be linked to the repeal of a discriminatory tax exemption in such a way that it amounts to a tax rebate that perpetuates the discriminatory taxation. Indeed, *Vogl* took this to be "one obvious point" in *Ragsdale*; "*Ragsdale* clearly endorses the notion that, just as a tax *exemption* that discriminates against federal retirees would violate the doctrine of intergovernmental tax immunity, so would a tax *rebate* that discriminates against federal retirees." *Id.* at 379 (citing *Ragsdale*, 895 P.2d at 1356). Thus, *Vogl* held that "in the world of intergovernmental tax immunity, substance does count." *Id.*

With respect to the 1995 Oregon law, the court observed that the State did the best it could to make the increase in benefits "approximate the amount needed to offset the effect of [the] 1991 repeal," *id.* at 380, but that "as with the 1991 increase, entitlement to the 1995 increase is not conditioned on *actual* liability for an equivalent amount in state taxes" and that state retirees receive the increase "even if they pay little

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increased tax liabilities following repeal of the exemption, and were not paid out of the general fund. *Id.* at 1354-56. On balance, the court rejected the idea that the increased benefits amounted to a tax rebate in violation of the intergovernmental immunity doctrine. *Id.* at 1357. As noted in text, Justice Gillette, the author of *Vogl*, dissented.

or no state income tax on their . . . benefits." *Id.* Thus, the court concluded:

> The upshot of the foregoing discussion is that, although the 1995 statute is similar to its 1991 predecessor in that it does not purport to offset, dollar for dollar, the amount lost to the exemption repeal in every individual case, its design and effect far more closely match such a purpose. Clearly, as the state moves closer to replacing the lost net income on a dollar-for-dollar basis, the fact that the increase is in fact a tax *rebate*, rather than a general increase in compensation to "make up" for lost net income becomes more apparent. That is particularly so in view of the fact that the increase is available *only in those years when [retirement] benefits are not tax exempt*. [*Id.* (emphasis in original).]

In addition, the Oregon court relied on the 1995 statute's express announcement that the increases were paid "'in compensation for damages suffered by members of [the retirement plan] . . . by reason of subjecting [retirement] benefits . . . to Oregon personal income taxation.'" *Id.* (omissions in original) (quoting 1995 Or. Laws, ch. 569, § 2(1)). The court explained that "[t]he state cannot have it both ways. It cannot claim that, for one purpose, the increase is legal compensation, *i.e.* damages, while, for other purposes, it is 'merely' a retirement 'benefit.'" *Id.* Thus, the court concluded: "The [benefits] increase purports to give [state] retirees what they were promised, *viz.*, tax-free retirement benefits. Because the retirees *were taxed*, the increase is the cure. And a cure for being overtaxed is a *rebate*." *Id.* at 380-81. Thus, "[t]aken collectively, the foregoing aspects of the 1995 statute satisf[ied] th[e] court that the benefit increase provided therein is, in substance, a tax rebate" and therefore unconstitutional. *Id.* at 381.

The South Carolina court's opinion in *Ward* directly conflicts with the analysis and the holdings of *Sheehy* and *Vogl*. *Ward* expressly states that an increase in retirement

benefits (or any other state compensation) can *never* be characterized as an unconstitutional tax rebate that violates the intergovernmental tax immunity doctrine. Relying on the Tenth Amendment, the *Ward* Court announced that a state's determination of state employees' compensation is *immune* from constitutional evaluation under the intergovernmental tax immunity doctrine:

> [T]he doctrine of intergovernmental tax immunity does not deprive a state of its sovereignty to establish the level of its employees' compensation as long as the State does not discriminate in taxation based on the source of the income. . . . The power to compensate state retirees is clearly not delegated to the United States by the Constitution. As long as federal and state retirees are taxed equally, any restriction on this [compensation] authority would violate the Tenth Amendment. [App. 3a-4a.]

And, *Ward* expressly holds that South Carolina is not "prohibited from adjusting the compensation of its employees, *even if the state's purpose is to compensate its employees for the loss of the income tax exemption*." App. 5a (emphasis supplied).

The *Ward* court's analysis is virtually identical to that of the Virginia court which upheld a state statute eliminating state retirees' income tax exemption, while increasing retirement benefits by three percent and making a lump sum payment of $15.75 million to state retirees. See *Almeter* v. *Va. Dep't of Taxation*, No. LL-821-4, 2000 WL 1687589, at *2 (Va. Cir. Ct. Nov. 6, 2000). Indeed, the *Almeter* court stated that "[b]ecause the actions complained about by plaintiffs, even if true, are the types of actions specifically contemplated and condoned by the Supreme Court of the United States in *Davis*, the plaintiffs have failed to state a cause of action." *Id.* *Almeter* thus read this Court's decision in *Davis* expressly to authorize states "to pay extra money to

state retirees to make up for what those retirees lost as a result of being taxed." *Id.*

Had the Montana and Oregon Supreme Courts accepted the analysis of *Ward* and *Almeter*, they would have upheld the Montana and Oregon taxation and benefit schemes that they struck down as unconstitutional. Under *Ward* and *Almeter*, the Montana and Oregon legislatures were simply exercising their unfettered, constitutionally-protected authority to determine state employee compensation. Indeed, according to *Ward* and *Almeter*, there is no constitutional problem under *Davis* and the intergovernmental tax immunity doctrine, even if the linkage between the repealed tax exemption and the increased state retirement benefits indisputably demonstrates that the scheme is in effect a tax rebate that preserves discriminatory tax treatment. See App. 4a; *supra* at 15. There is, accordingly, a square and fundamental conflict between *Ward* and *Almeter*, on the one hand, and *Sheehy* and *Vogl*, on the other.

There is a significant corollary confusion among the state courts that have addressed whether the states' statutory responses to *Davis* are constitutional. There is no settled test for determining whether compensation increases are constructive tax rebates. In analyzing this question, state courts have considered the legislatures' articulated purpose, the simultaneity of the tax exemption repeal and the compensation increase, and the correlation between the coverage and the costs imposed by the repeal and the coverage and the amount of compensation provided by the benefit increase. But, the courts are wholly confused about how much linkage between tax exemption repeals and increased benefits warrants characterization of a benefit increase as a tax rebate.

This confusion is clearly evinced in the outcomes in the state Supreme Courts on the issue. There are substantial, critical similarities among all the state schemes at issue in *Ward*, *Almeter*, *Sheehy*, *Ragsdale*, and *Vogl* and only minor

differences among them. Yet, the courts reached conflicting conclusions by attaching varying degrees of importance to different factors. See Dan T. Coenen & Walter Hellerstein, *Suspect Linkage: The Interplay of State Taxing and Spending Measures in the Application of Constitutional Antidiscrimination Rules*, 95 Mich. L. Rev. 2167, 2179-81 (1997) (discussing the conflict between *Sheehy* and *Ragsdale*). In *Sheehy* and *Vogl*, for example, each court appeared to find the combined effect of the state's evident purpose and the rough correlation between the increased tax burden and the benefit increases sufficient evidence of linkage to render the legislation a tax rebate, at least where the state is crafting a remedy for a past constitutional violation. In *Ward*, *Almeter*, and *Ragsdale*, similar demonstrations were deemed either irrelevant (in the first two cases) or inadequate (in the third).

In *Ward*, South Carolina did not dispute that the General Assembly increased the state retirees' benefits to offset their increased tax obligations resulting from Act 189's repeal of the tax exemption. See App. 3a; see also *Ward*, 538 S.E.2d at 246 n.4 ("[s]ections 39 and 60 link the increase in state retirement benefits to the elimination of the tax exemption for state retirees' benefits"); *Evans* v. *South Carolina*, 543 S.E.2d 547, 549 (S.C. 2001) ("the General Assembly increased the pension benefits for state retirees by 7% to offset the increased tax liability resulting from the lost exemption"). And, although the court found that the benefit increase did not provide dollar-for-dollar compensation for the increased tax burden, the record demonstrated that the correlation was very high. See, *e.g.*, 1989 Report of the South Carolina Retirement System (discussing *Davis* and Act 189, stating "our retirement benefits formulas were enhanced so as to not penalize retirees as a result of this legislation"), *reproduced as* Compl. Exh. B, Record on Appeal at 75, *Ward* v. *South Carolina*, 590 S.E.2d 30 (S.C. filed May 13, 2003); Rainwater Dep. Exh. A (a calculation demonstrating how to increase benefits to offset the new taxes imposed on state

retirees), *reproduced as* Exh. C to Mot. for Summ. J., Record on Appeal at 91, *Ward* v. *South Carolina*, 590 S.E.2d 30 (S.C. filed May 13, 2003). In other words, had the *Ward* court given effect to this linkage, as the *Sheehy* and *Vogl* courts did, it would have found that Act 189 enacted an unconstitutional tax rebate.

This Court should grant the petition to resolve the conflict among state courts on the question whether state statutes increasing state employee compensation can constitute constructive tax rebates in violation of the intergovernmental tax immunity doctrine or whether states have unreviewable power to perpetuate discrimination by substituting compensation for a prior tax exemption. The Court should simultaneously clarify the standard for determining when the linkage between the repeal of a tax exemption and an increase in compensation demonstrates that the latter is an unconstitutional tax rebate.

II. THE SOUTH CAROLINA COURT'S OPINION IS IN SUBSTANTIAL TENSION WITH THIS COURT'S PRECEDENTS.

The decision below is in substantial tension with *Davis* and with this Court's dormant Commerce Clause jurisprudence embodied in *West Lynn Creamery, Inc.* v. *Healy*, 512 U.S. 186 (1994). By approving Act 189, the South Carolina Supreme Court permitted the circumvention of *Davis*' directive that the states accord federal retirees equal tax treatment. In addition, the court's rejection of petitioners' "indisputable linkage" argument cannot be reconciled with *West Lynn Creamery* which, in the analogous dormant Commerce Clause context, requires courts evaluating state taxation of commerce to make a substantive inquiry into the discriminatory effect not only of taxation, but of linked tax rebates or subsidies.

(A) *Ward* manifestly conflicts with this Court's directive in *Davis* that states end their discriminatory taxation of federal

retirees. Whatever freedom to act a state possesses *before* this Court determines that one of its statutes is unconstitutional, once this Court has done so, the affected state is obliged to enact a *remedy* curing the unconstitutionality of the prior statute. Here, the affected states may not avoid their remedial obligation to afford state and federal retirees equal treatment by manipulating the state compensation and taxation schemes to provide flatly unequal treatment.

Although *Davis* presented the states with a choice between alternative remedies, the choice was a hard one. States were required either to extend state retirees' exemptions to federal retirees and give up the revenues realized from taxes on federal retirement benefits, or to eliminate the tax exemption for state retirees and accept the political consequences of that act. See *Reynoldsville Casket Co.* v. *Hyde*, 514 U.S. 749, 755 (1995) (*Davis* requires the states to cure their differential treatment of federal and state retirement benefits "either by similarly burdening, or by similarly unburdening, both groups"). Neither choice is politically attractive. State legislatures are loath to extend the availability of tax exemptions, particularly if that act results in a need for across-the-board tax increases. States legislatures are also unwilling to raise the tax burden of state employees and retirees who frequently constitute a powerful bloc of voters.

South Carolina and other states chose to avoid making this hard political decision. Instead, they simultaneously eliminated the tax exemption for state retirement benefits and increased the benefits paid to state retirees. These states thus preserved the stream of tax revenues from federal retirees without raising taxes and placated state retirees who lost their tax exemption by increasing their benefits in an amount that roughly corresponded to the increased tax burden. Put differently, South Carolina and others enacted a combination of new taxes and new benefit payments in order to keep the

state treasury and state retirees in practically the same financial position they occupied before *Davis*.

Particularly where, as here, the affected states are in the procedural posture of remedying an established constitutional violation, there are two reasons that the federal courts must not allow the states to evade the hard choice posed by *Davis* in this manner.

First, the political process will not protect the remedial mandate of equal treatment for state and federal retirees. Federal retirees are not a substantial bloc of voters; state retirees and employees are certain to exert political pressure to maintain their favorable treatment; and the greater body of voters is uninterested in giving federal employees a tax break that might increase taxes overall. Cf. *W. Lynn Creamery*, 512 U.S. at 200 ("[W]hen a nondiscriminatory tax is coupled with a subsidy to one of the groups hurt by the tax, a State's political processes can no longer be relied upon to prevent legislative abuse, because one of the in-state interests which would otherwise lobby against the tax has been mollified by the subsidy."). South Carolina's failure to provide an appropriate remedy, though understandable, nonetheless violates *Davis*, and federal retirees must look to the courts rather than the political process for enforcement of their right to equal treatment.

Second, South Carolina's facile evasion of the alternative *Davis* remedies threatens the institutional integrity of the Court. This Court has found a constitutional violation and issued a remedial mandate requiring equal treatment. In most situations, a state's decision to increase its employees' and retirees' benefits is none of the Court's concern. Here, however, the State's decision to increase retiree benefits is for the purpose of circumventing this Court's mandate to end discrimination and provide equal treatment.

The decision below entirely fails to take into account that a constitutional remedy should "restore the victims of

discriminatory conduct to the position they would have occupied in the absence of such conduct." *Milliken* v. *Bradley*, 433 U.S. 267, 280 (1977) (internal quotation marks omitted) (quoting *Milliken* v. *Bradley*, 418 U.S. 717, 746 (1974)); *United States* v. *Virginia*, 518 U.S. 515, 547 (1996) (the objective is to "eliminate [so far as possible] the discriminatory effects of the past and to bar like discrimination in the future") (internal quotation marks omitted, alteration in original) (quoting *Louisiana* v. *United States*, 380 U.S. 145, 154 (1965)). In states like South Carolina, where legislatures have eliminated discriminatory tax exemptions but also have offset the new taxes, federal retirees manifestly were not placed in the position they would have occupied absent the original discrimination. These states have not cured but have instead perpetuated their schemes of discriminatory taxation. No court would permit a state similarly to evade enactment of an effective remedy for, *e.g.*, unlawful race or gender discrimination. Cf. *Green* v. *County Sch. Bd.*, 391 U.S. 430, 439-41 (1968) (rejecting freedom-of-choice plan as a remedy for unconstitutional school segregation); *Wright* v. *Council of Emporia*, 407 U.S. 451 (1972) (enjoining local officials from carving out new school districts to prevent school integration).

Indeed, according to *Ward* and *Almeter*, the sole consequence of the Court's decision in *Davis* is that the state must employ some fiscal tool other than a tax exemption to put the monetary benefit of the tax exemption in the state retirees' pocket. If this is true, then the intergovernmental tax immunity doctrine is little more than a rule of procedure, and certainly not a substantive protection for federal employees. Of course, it is not true; and for this reason, too, the South Carolina Supreme Court's decision is in significant tension with *Davis*.

(B) *Ward*'s holding that it is *irrelevant* whether there is a link between South Carolina's simultaneous increase in benefits and repeal of a discriminatory tax exemption cannot

be reconciled with the analysis in *West Lynn Creamery*. That case involved a Massachusetts program that assessed a premium payment on out-of-state and in-state producers of fluid milk selling their product to Massachusetts retailers. Roughly two-thirds of the milk producers were from out of state, but the aggregate assessment was distributed in its entirety to Massachusetts dairy farmers. See 512 U.S. at 188.

Although the assessment was levied on in-state and out-of-state producers, the Court found the assessment discriminatory because it was offset by a subsidy paid solely to in-state dairy farmers from the assessed funds. *Id.* at 194; see *id.* ("[l]ike an ordinary tariff, the tax is thus effectively imposed only on out-of-state products"). Massachusetts defended its program by arguing that each element – the nondiscriminatory tax and the separate subsidy to in-state dairy farmers – was constitutional, so the whole program must be constitutional. This Court first noted the "err[or] in assuming that the constitutionality of the pricing order follows logically from the constitutionality of its component parts." *Id.* at 199. Critically here, the Court rejected the State's argument, because it "would require us to analyze separately two parts of an integrated regulation, but we cannot divorce the premium payments from the use to which the payments are put." *Id.* at 201.

Thus, in its dormant Commerce Clause jurisprudence, this Court has held that where taxes and subsidies are linked, a subsidy can convert a facially nondiscriminatory tax into an unconstitutionally discriminatory one. And, relevant here, the Court has made clear that dormant Commerce Clause cases are "conceptually similar [to the] field of intergovernmental taxation, where nondiscrimination also plays a central role in setting the boundary between the permissible and the impermissible." *Id.* at 200 n.17. See also Coenen & Hellerstein, *supra*, at 2168 ("[i]n each of these settings, the essential problem is the same: whether courts should view the state taxing and spending measures as an integrated whole or

as independent components of the law for purposes of constitutional analysis"); *Acker*, 527 U.S. at 439 (noting that "[t]he practical impact, not the State's name tag," determines whether something fits within the Public Salary Tax Act); *Kerr* v. *Killian*, No. CV-03-0110-PR, 2004 WL 258200, at *8 (Az. Feb. 13, 2004) (en banc) (explaining that it was required to examine the Arizona tax scheme's "practical operation" and that "[i]f the inevitable consequence of a facially neutral state tax code were that federal employees were taxed differently than similarly situated state employees because of the source of their income, or if the distinctions drawn in the state code were 'only a cloak for discrimination against federally funded [pay or compensation],' [4 U.S.C. §] 111(a) would plainly invalidate such a scheme.") (first alteration in original) (quoting *Barker* v. *Kansas*, 503 U.S. 594, 604-05 (1992)).

Ward cannot be harmonized with the analysis of *West Lynn Creamery*. Indeed, *Ward* held as a matter of law that courts assessing remedies for discriminatory taxation may not even consider whether a compensation increase is "indisputabl[y] link[ed]" to the demise of a tax exemption. See App. 4a. In light of the close analogy between this Court's dormant Commerce Clause and intergovernmental tax immunity doctrines, we submit that the decisions are in conflict; clearly, the decisions cannot be coherently reconciled.

The decision below is in substantial tension with both *Davis* and *West Lynn Creamery*; and this Court should grant the petition to resolve that tension, as well as the conflict among the lower courts.

III. THE CASE PRESENTS AN IMPORTANT AND RECURRING QUESTION OF FEDERAL LAW.

The petition is also worthy of the Court's attention because it presents an important and recurring question of federal law with respect to the intergovernmental tax immunity doctrine

that also has significant implications for cases arising under the dormant Commerce Clause.

The intergovernmental tax immunity doctrine plays an important role in the preservation of the Constitution's balance of power between the federal and state sovereigns. Because "the power to tax involves the power to destroy," *McCulloch*, 17 U.S. (4 Wheat.) at 429, an enlargement of the state's taxation powers at the expense of the federal government raises important constitutional concerns, *Davis*, 489 U.S. at 809. This case, moreover, presents an intergovernmental tax immunity question of unique importance for several reasons.

First, *Ward* squarely presents the question whether states may circumvent the remedial mandate of equal treatment by eliminating a tax exemption and simultaneously providing compensation for the increased tax burden. The *Ward* court held that states may always do so, and that the federal courts have no power to review state compensation decisions for unconstitutionality under the intergovernmental tax immunity doctrine. If this holding is correct, the doctrine has lost much of its importance. Moreover, if the holding is transferred to the analogous dormant Commerce Clause arena, the states have a new and enhanced power to subsidize their own citizens and industries, even if their taxation schemes are manifestly discriminatory. See Coenen & Hellerstein, *supra*, at 2172-73. If these important constitutional doctrines are to be rendered ineffectual in this manner, a counter-intuitive proposition, then the decision should be made by this Court.

Second, *Ward* directly raises the specific question whether the states may lawfully respond to this Court's decision in *Davis* by using fiscal tools other than taxation to maintain state retirees' favored position. *Davis* was an important case to tens of thousands of federal retirees; it promised federal retirees in 23 states that they would somehow receive equal treatment and many retirees have seen the mandate of equal treatment fulfilled. In the states that have sought to preserve

state retirees' favored status, however, the state courts are divided on the question of what constitutes equal treatment for state and federal retirees. That division has meant that federal retirees have received fundamentally different remedies in states that have enacted substantially similar remedial responses to *Davis*. This lack of uniformity in the remedial response to *Davis* is profoundly unfair to federal retirees. Indeed, as set forth above, it is important that this Court both resolve the conflict about the remedies for the constitutional violation in *Davis* and make clear that its remedial mandate cannot be so easily evaded.

A third and related point is that the issue presented in this case – the constitutional significance of retirement benefits increases that are linked to repeals of discriminatory tax exemptions – is one that is likely to recur. The issue was presented in all the cases described *supra*; in addition, a materially identical case is currently pending before the Utah Supreme Court. See *Thompson* v. *Utah State Tax Comm'n*, No. 20030506-SC (Utah filed June 13, 2003). If *Ward* and *Almeter* are permitted to stand, other states will be encouraged to follow their lead and enact linked repeals of tax exemptions and compensation increases for state employees.

Finally, this Court is the sole federal forum with jurisdiction to resolve the important constitutional issue posed by the petition and to end the conflicting approaches taken by the state courts. The Anti-Tax Injunction Act, 28 U.S.C. § 1341, precludes federal retirees like Ward from seeking prospective relief against such tax regimes. In addition, the Eleventh Amendment and this Court's prudential decisions, see, *e.g.*, *Fair Assessment in Real Estate Ass'n, Inc.* v. *McNary*, 454 U.S. 100, 116 (1981), make other federal courts unavailable to federal retirees challenging discrimination in state taxation. This Court is uniquely situated to address and resolve the important and recurring legal issue presented here.

IV. THE SOUTH CAROLINA COURT'S DECISION WAS WRONG.

The principal holding of *Ward* is that courts lack the power to review a state legislature's decision to increase state employees' compensation or state retirees' retirement benefits. This is wrong for numerous reasons.

First, in this case, the South Carolina legislature was acting against the backdrop of this Court's decision in *Davis*. In that case, the Court found a constitutional violation and ordered the states to remedy that violation by eliminating discrimination and providing equal treatment. In this setting, the states were not free to employ an alternative fiscal tool to perpetuate the extant discrimination. And, the federal remedial mandate barring such action clearly does not violate the Tenth Amendment.

In any event, this Court requires that the constitutionality of any taxation measure be assessed according to its practical impact or effect. See *Acker*, 527 U.S. at 439 (emphasizing that "[t]he practical impact, not the State's name tag," controls); *W. Lynn Creamery*, 512 U.S. at 194-95 & n.10 (citing the actual results of the Massachusetts program). *West Lynn Creamery* also teaches that the constitutional inquiry is not limited to the taxation component of an enactment; the effects of an integrated legislative program must be jointly considered. *Id.* at 201 (refusing to "analyze separately two parts of an integrated regulation"). Thus, where a taxation measure is linked with a subsidy measure in such a way that the two comprise an "integrated regulation," the effects of the enactments must be jointly evaluated.

There is no doubt that South Carolina's repeal of its discriminatory tax exemption is linked with its increase in state retirement benefits such that the effects of the two measures must be considered together. Indeed, South Carolina acknowledged that the provisions were linked, as did the South Carolina Supreme Court on several occasions. See

supra at 17-18, 23. The provisions were enacted simultaneously within the same public law. South Carolina intended to maintain its retirees' favored position. Although the motive for a benefit increase may not be entirely dispositive of the constitutional question, South Carolina's concession of linkage, along with the simultaneity of the enactments, is highly relevant. See App. 3a ("[t]he State does not dispute that the General Assembly increased retirement benefits to compensate state retirees, in part, for their increased income tax obligations resulting from the enactment of Act 189"). In addition, the coverage of the new tax and that of the new benefits substantially overlap. See *Sheehy*, 864 P.2d at 768 (noting the identical scope of Montana's new tax and benefit regimes). Similarly, while the correlation between South Carolina's new taxes on its retirees and the new benefits it pays to them is not absolutely dollar for dollar, see App. 6a, Act 189's seven percent increase in benefits for state retirees was designed to offset their increased tax obligations as closely as possible, and the State has *acknowledged* the linkage between the two. See *supra* at 17-18; App. 3a. The State was attempting to replace a discriminatory tax exemption with a discriminatory tax rebate.

Indeed, there is little legitimate justification for the usual deference to state compensation decisions here; increasing the benefits of those already retired does not encourage them to maintain their state employment. Under the circumstances presented, the *Ward* court should have considered the repealed tax exemption and the increased benefits jointly and should have held that the increased benefits are a discriminatory "tax rebate denominated otherwise in an attempt to evade the requirements of federal law." *Sheehy*, 864 P.2d at 768.

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In sum, this Court should grant the petition to resolve the conflict among the state courts on the important and recurring issue of constitutional law presented by the petition, to

overturn the state court decisions that cannot be reconciled with this Court's decisions in *Davis* and *West Lynn Creamery*, and to hold that linking the repeal of a discriminatory tax exemption with an offsetting increase in those benefits violates the non-discrimination mandate of the intergovernmental tax immunity doctrine.

CONCLUSION

The petition for certiorari should be granted.

Respectfully submitted,

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